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TAKING NOTE OF THE INVESTMENT ASPECT OF PURCHASING A FRANCHISE: A PROPOSAL FOR REQUIRED ELECTRONIC FILING OF PRE-SALE DISCLOSURE DOCUMENTS

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I. INTRODUCTION

While exact figures may be unavailable, a very large percentage of retail goods and services are distributed through franchised outlets.¹ It is therefore unremarkable that this business strategy receives so much attention.

In spite of all the attention that Congress² and the Federal Trade Commission have devoted to franchising, there is little regulation at the federal level.³ To be sure, the Federal Trade Commission's Franchise Rule⁴ requires pre-sale disclosure with respect to most offers of franchise units. However, there is no requirement that the disclosure document be filed with the Federal Trade Commission or any other federal agency or official. In

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¹ See generally PRICEWATERHOUSECOOPERS, *THE ECONOMIC IMPACT OF FRANCHISED BUSINESSES PART II: A STUDY FOR THE INTERNATIONAL FRANCHISE ASSOCIATION EDUCATIONAL FOUNDATION* (2004).

² Over the years, Congressman John LaFalce (D-NY) has introduced a number of bills that would regulate franchising in one way or another. *E.g.*, the Federal Fair Franchise Act of 1997, H.R. 2954, 105th Cong. (1st Sess. 1997). Other members of Congress have also introduced bills that would impose federal regulation of franchising. *E.g.*, Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. (1st Sess. 1999), sponsored by Howard Coble (R-NC) and John Conyers (D-MI). None of these bills have been adopted into law.

³ The two federal statutes dealing with franchising regulate franchising in specific industries in which Congress determined there were problems meriting federal intervention. These statutes are the Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2806 (2006), and The Automobile Dealers' Day in Court Act, 15 U.S.C. §§ 1221-1226 (2006).

⁴ I will use the term "Franchise Rule" to refer to both the original Rule promulgated in 1978, and the revised Rule adopted in 2007. Where I intend to refer specifically to the original or the revised Rule, I will make this intention clear. See Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436 (2009).

addition, the franchise relationship itself is not subject to significant federal regulation.

Because of the significant stakes involved in franchising and the potentially conflicting interests of franchisors and franchisees, there is continuing disagreement about a number of issues including, but not limited to: i) whether a federal filing requirement for franchise disclosure documents should be imposed; ii) whether states' pre-sale disclosure laws should be pre-empted;⁵ iii) whether there should be a private cause of action for violation of the Federal Trade Commission's Franchise Rule;⁶ iv) whether there is a need for federal regulation of the franchise relationship itself, either by the Federal Trade Commission or new legislation; and v) whether there is need for federal regulation of the franchise relationship and, if so, the form such regulation should take.

I will only attempt to answer the first of these questions. However, I believe the answer I suggest may help pave the way for productive consideration of the remaining questions.

After a brief discussion of the assumptions guiding my analysis, I will discuss some rough similarities between the franchise relationship and the sale of common shares, and their different treatment under the federal securities laws. I will then give a brief comparison of the federal regulatory schemes governing public offerings of securities and the offering of franchise interests. I will conclude with a proposal that franchisors be mandated to electronically file the pre-sale disclosure document already required to be provided to prospective franchisees by the Franchise Rule,⁷ and a brief discussion of the implementation of this proposal.

II. BACKGROUND: MY ASSUMPTIONS

In thinking about the question of whether a federal filing requirement for franchise disclosure documents should be imposed, I tried to identify the assumptions that would guide my thinking. By identifying

⁵ The Federal Trade Commission has rejected calls to expressly preempt state pre-sale disclosure requirements. Therefore, the Franchise Rule preempts state requirements only "where it is impossible for a private party to comply with both state and the Commission regulations, or where application of state regulations would frustrate the purposes of the Franchise Rule." Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, 15537 (Mar. 30, 2007).

⁶ The federal courts have held that there is no private cause of action for a violation of the Federal Trade Commission's Franchise Rule. See *Morrison v. Back Yard Burgers*, 91 F.3d 1184, 1187 (8th Cir. 1996).

⁷ In 1993 Congressman John LaFalce proposed legislation that would have required a person offering franchises for sale to file a franchise disclosure document with the United States Department of Commerce. See Federal Franchise Data and Public Information Act, H.R. 1317, 103d Cong. § 3 (1st Sess. 1993) and Federal Franchise Data and Public Information Act H.R. 2595, 103d Cong. § 3 (1st Sess. 1993).

the assumptions that are guiding my analysis, I hope to assist readers in thinking critically about my proposal.

First, there is an insufficiency of data regarding franchising generally, including the incidence of abuses by franchisors.⁸ While there have been numerous franchise bills introduced in Congress, many Federal Trade Commission proceedings held, and several General Accounting Office reports issued, no one really knows for certain how many franchise systems exist or how many franchise units are in operation.⁹ Further, there continues to be strong disagreement regarding the prevalence of abuses by franchisors and the adequacy of existing laws to deal with those abuses that exist. There is, to be sure, much anecdotal evidence regarding franchisor abuses. One need only read some of the testimony before congressional committees or subcommittees, or some of the letters submitted to such committees, to be aware that there are certainly a number of franchisees who believe they have been subjected to abuse by franchisors.¹⁰ Of course, the pertinent franchisors may have different views of the events described by their franchisees.¹¹

Second, there appears to be widespread agreement, even among franchisors, that pre-sale disclosure is good. Of course, there remains some disagreement regarding the extent and nature of the pre-sale disclosure that should be required. For example, there continues to be vigorous

⁸ "The extent and nature of franchise relationship problems are unknown because of a lack of readily available, statistically reliable data - that is, the data available are not systematically gathered or generalizable." U.S. GEN. ACCOUNTING OFFICE, FEDERAL TRADE COMMISSION ENFORCEMENT OF THE FRANCHISE RULE 4, GAO-01-776 (July 2001).

⁹ The U.S. Bureau of Census 2007 Economic Census includes questions about franchising. The data gathered "will provide the first hard data available on the economic impact of franchising across many industries, and will serve as the foundation for a new report entitled Franchising." U.S. Census Bureau, *Guide to the 2007 Economic Census: What's New for 2007*, available at <http://www.census.gov/econ/census07/guide/g07new.htm> (last visited Mar. 2, 2009).

¹⁰ See *Franchising Relationship: Hearing Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 106th Cong., 1st Sess. 84-90 (1999), available at http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (statement of Patrick James Leddy, Jr., a Baskin-Robbins franchisee) and *id.* at 109-122 (statement of Darrell Dunafon, a former Taco Bell franchisee) (last visited Mar. 2, 2009).

¹¹ See, e.g., *Franchising Relationship: Hearing Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 106th Cong., 1st Sess. 307-311 (1999), available at http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (letter from parent company of Taco Bell responding to testimony of Darrell Dunafon, a former franchisee) and *id.* at 342-343 (prepared statement of Baskin-Robbins, incorporating response to testimony of James Leddy, Jr., a Baskin-Robbins franchisee) (last visited Mar. 2, 2009).

disagreement about whether franchisors should be compelled to disclose data regarding the financial performance of franchise units. Compelling arguments can be made on both sides of this issue.¹²

Third, putting aside the question of disclosure of financial performance representations, the existing system of pre-sale disclosure is inadequate because it fails to provide prospective franchisees with some very important information—namely, information about competing franchise systems. Without belaboring the point, consider the ability of the prospective franchisee to “shop around” and encroachment by the franchisor.

Much is often made of the prospective franchisee’s ability to consider other franchise systems and opportunities. As a practical matter, this may not be all that easy. Franchisors often are not eager to provide disclosure documents to parties before they have expressed a serious interest in the franchise system. Under the revised Franchise Rule, a franchisor may be able to carry on extensive discussions with a prospective franchisee and require a significant amount of information from the prospective franchisee so long as the required disclosures are made “at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.”¹³ In addition, there is no inexpensive and easy manner to obtain franchise disclosure documents from other sources.¹⁴ In sum, meaningful “shopping around” may be difficult.¹⁵

Further, much attention has been devoted to franchisor encroachment.¹⁶ A number of the unsuccessful bills that have been

¹² See generally BUREAU OF CONSUMER PROTECTION, STAFF REPORT TO THE FTC AND PROPOSED REVISED TRADE REGULATION RULE (16 C.F.R. § 436): DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING 160-161 (2004), <http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf> (summarizing arguments of franchisees and franchisors).

¹³ 16 C.F.R. § 436.2 (2008). A franchisor must provide a prospective franchisee with a copy of the franchise disclosure document at an earlier time “upon reasonable request.” 16 C.F.R. § 436.9(e) (2007). However, this assumes that the prospective franchisee is aware of the right to make such a request and also poses the question of when a request is “reasonable.” Must the prospective franchisee exhibit serious interest, i.e., demonstrate that he or she is not a mere “tire-kicker,” before the request is reasonable?

¹⁴ A prospective franchisee can purchase franchise disclosure documents from a private company such as FRANData. However, these will generally cost two to three hundred dollars each. See generally FRANData website, <http://www.frandata.com>.

¹⁵ Of course, if most franchise agreements, at least with a particular type of retail business, contain pretty much the same terms, then the ability of a prospective franchisee to shop around may be quite limited. However, this might be useful information to the prospective franchisee who may have the option of starting an independent business. In addition, this information could be useful to policymakers.

¹⁶ Encroachment involves “the practice by which a franchisor essentially competes with its franchisees by establishing franchisor-owned or new franchised-outlets in the same

introduced in Congress over the years would address this perceived problem.¹⁷ In addition, the revised Federal Trade Commission Franchise Rule expands the disclosure requirements regarding territory in several respects,¹⁸ including: i) disclosure of plans of the franchisor to operate a competing franchise system offering goods and services similar to those of the franchise system; ii) disclosures to address new technologies and market developments;¹⁹ and iii) where the franchisor does not grant an exclusive territory, a prescribed warning about the impact of buying a franchise with a non-exclusive territory.

Not surprisingly, the revised Rule does not require disclosure of similar information regarding competing franchise systems not affiliated with the franchisor filing the disclosure document. However, this information may be very significant to a prospective franchisee. In addition to desiring information regarding competition by the franchisor, a prospective franchisee would want to know about potential competition by other franchise systems. The revised Franchise Rule does not (and should not) require disclosure of this information by the franchisor; this would be an unreasonable (if not impossible) burden to place on the franchisor.

Fourth, Federal Trade Commission enforcement of its Franchise Rule is not very vigorous. The Commission's statistics indicate that the

market territory, by purchasing and operating a competing franchise system, or by selling the same goods or services through alternative channels of distribution." Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed.Reg. 15444, 15491 (Mar. 30, 2007).

¹⁷ See The Federal Fair Franchise Practices Act, H.R. 1717, 104th Cong. § 8 (1995).

¹⁸ E.g., 16 C.F.R. § 436.5(l) (2008); see also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15444, 15551-52 (Mar. 30, 2007).

¹⁹ This disclosure includes, among other things:

- (i) Any restrictions on the franchisor from soliciting or accepting orders from consumers inside the franchisee's territory, including:
 - (A) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing sales, to make sales within the franchisee's territory using the franchisor's principal trademarks.
 - (B) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing, to make sales within the franchisee's territory of products or services under trademarks different from the ones the franchisee will use under the franchise agreement.
 - (C) Any compensation that the franchisor must pay for soliciting or accepting orders from inside the franchisee's territory.

16 C.F.R. § 436.5(l)(6) (2007).

majority of complaints received under the old franchising and business opportunity rule related to business opportunities and not franchises. In addition, the Commission investigates only a small portion of the complaints related to franchises and brings enforcement actions in an even smaller number of cases.²⁰ The small number of franchise-related complaints sometimes has been offered as evidence of the lack of widespread abuses in franchising. However, an equally plausible explanation is that franchisees are aware that the Federal Trade Commission Franchise Rule does not regulate the franchise relationship²¹ and that, even as to disclosure issues, the Commission generally will not pursue enforcement of individual complaints.²²

Fifth, there is, in essence, no effective enforcement of pre-sale disclosure requirements in a majority of states. While fifteen states have laws mandating pre-sale disclosure,²³ in a majority of states the only pre-sale disclosure obligation is that imposed by the Federal Trade Commission's Franchise Rule. Given that there is no private cause of action to enforce this Rule²⁴ and that the Federal Trade Commission brings

²⁰ See U.S. GEN. ACCOUNTING OFFICE, *supra* note 8, at 10-18.

²¹ Cf. the comments of Dale E. Cantone, Deputy Securities Commissioner, Office of the Maryland Attorney General:

We hear about abuses all of the time, but I don't think we hear about abuses to the extent they exist in the marketplace for some of the same reasons that we have talked about. I go out and speak to franchisees and hear stories about renewal problems or encroachment issues, but for many reasons franchisees don't complain to my office because they don't complain to the FTC because they realize we don't have jurisdiction to handle these issues.

We haven't had a complaint about encroachment in our office for more than 5 years, but we hear time and again that it is a real issue.

The FTC's Franchise Rule: Twenty-three Years After its Promulgation: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the Comm. on Energy and Commerce, 107th Cong., 2d Sess. (2002) (Dale E. Cantone, responding to a question from Representative Shimkus), available at <http://energycommerce.house.gov/reparchives/107/hearings/06252002Hearing603/print.htm>.

²² The Federal Trade Commission considers the "level of consumer injury and number of consumers affected to determine whether it is in the public interest to open an investigation [I]ndividual complaints may not show that a company has engaged in a pattern or practice of illegal conduct that would warrant opening an investigation." See U.S. GEN. ACCOUNTING OFFICE, *supra* note 8, at 14.

²³ See generally Federal Trade Commission, State Offices Administering Franchise Disclosure Laws, available at <http://www.ftc.gov/bcp/franchise/netdiscl.shtml> (last visited Mar. 2, 2009).

²⁴ *Morrison*, 91 F.3d at 1187.

few enforcement actions under the Rule,²⁵ it is likely that there is an absence of meaningful enforcement of the Rule in these states.²⁶ Of course, this does not mean that there are necessarily widespread violations of the Rule. Certainly many franchisors desire to be in compliance with the law and will attempt to comply with the Rule. However, we do not have adequate information to accurately judge the level of compliance in these states.

Finally, there is general agreement that any system of franchise regulation should not overburden franchisors. As others have pointed out, the franchisor always has the option of vertically integrating the business and eliminating the franchisees.²⁷ Presumably at some point the burden of complying with a system of franchise regulation could make vertical integration much more attractive as a business strategy.²⁸

A system of franchise regulation that is extremely onerous could have a number of negative consequences. These include foreclosing opportunities for prospective franchisees, many of whom may be women or minorities, as well as limiting the use of a business strategy that has proven to be extremely effective in enabling the rapid expansion of a business by coupling the franchisor's intellectual property and know-how with the franchisees' capital and labor.

²⁵ See U.S. GEN. ACCOUNTING OFFICE, *supra* note 8, at 84-90 and *supra* note 20 (accompanying text).

²⁶ Where the disclosure document provided pursuant to the Franchise Rule contains a material misstatement, a franchisee may have a cause of action for common law fraud provided the elements of the tort are present. However, there is no common law cause of action where no disclosure document is provided and generally no cause of action where the disclosure document fails to provide information required by the Franchise Rule.

²⁷ "An alternative to franchising is vertical integration." Nancy A. Lutz, *Ownership Rights and Incentives in Franchising*, JOURNAL OF CORPORATE FINANCE (1995), reprinted in FRANCHISE CONTRACTING AND ORGANIZATION 136 (Francine Lafontaine ed., 2005).

²⁸ See, e.g., *Franchising Relationship: Hearing Before the Subcomm. On Commercial and Admin. Law of the House Comm. on the Judiciary*, 106th Cong., 1st Sess. 170 (1999), available at http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (last visited Mar. 2, 2009) (statement of Dennis E. Wiczorek, Esq.) ("Krispy Kreme has told me that if legislation along the lines of what we have heard about and seen in prior years is passed, that they would cease franchising immediately."). On the other hand, it has been asserted: "Were the franchisor to seek to grow it's [sic] business by instead obtaining capital through the debt or equity markets, those share holders or lenders would have a much higher level of protection than that enjoyed by franchisees." *Id.* at 235 (1999) (prepared statement of Spencer D. Vidulich, O.D., Pearle Vision). Presumably, if the former franchisor sought to raise capital for expansion by making a public offering of common shares, it would be required to register the offering with the Securities and Exchange Commission.

Of course, there is vigorous debate about the potential impact of various forms of franchise regulation that have been proposed, including federal franchise relationship laws and a private federal cause of action. While some have predicted an explosion of litigation and the death of franchising,²⁹ others have suggested that “leveling the playing field” and providing clear rights to franchisees will actually reduce litigation and strengthen franchising as a business strategy.³⁰ One need not solve the debate regarding the potential impact of measures that have been proposed to accept the proposition that at some point the burden of additional regulation will outweigh the benefit. It is in no one’s interest to go beyond this as of yet undefined point.

III. CATEGORIZING THE FRANCHISE RELATIONSHIP

In thinking about the franchise relationship, one can begin by attempting to categorize the relationship, as well as the nature, of a franchise. In reading testimony, reports, and comments about franchising, one encounters a number of terms and phrases. These include “family,”³¹ “partnership,”³² “indentured servitude,”³³ and “marriage.”³⁴

Often the position a party takes regarding the regulation of the franchise relationship influences the manner in which he or she characterizes it. For example, if one characterizes the franchise relationship as a “business partnership,” then one might argue that the relationship itself

²⁹ *Id.* at 181 (1999) (prepared statement of Dennis E. Wieczorek, Esq.) (“At the end of the day, oppressive legislative restrictions on the operation of franchise relationships, and the litigation that is sure to follow, will simply stop franchising in its tracks.”).

³⁰ *Id.* at 348, 351 (letters of Shawn Perry and Marc Blumenthal, respectively, arguing that such legislation would reduce litigation); *see also id.* at 353-356 (prepared statement of Jeffrey S. Haff asserting that franchising “continues to flourish” in Minnesota after adoption of the Minnesota Franchise Act and dismissing the “parade of horrors offered up by franchisor advocates”) and *id.* at 311-312 (letter of Brent R. Appel asserting that adoption of the Iowa Franchise Act did not result in a litigation explosion).

³¹ *Id.* at 152 (comment of Michael F. Adler, President and CEO, Moto-Photo, Inc.).

³² *Id.* at 77 (statement of Michael F. Adler, President and CEO, Moto-Photo, Inc.). Mr. Adler also stated: “We try to operate as a team . . . we always strive to have a win/win situation . . . we have carried many of our franchisees longer than their mother carried them.” *Id.* at 75.

³³ *Id.* at 187, 266, 336 (1999) (comment of Peter Singler, Esq., prepared statement of Patricia & Michael Smith-Bradley, and letter from Harris Chernow, respectively).

³⁴ “It is a long-term relationship. It is like a marriage.” *The FTC’s Franchise Rule: Twenty-three Years After its Promulgation: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the House Comm. on Energy and Commerce*, 107th Cong. 54 (2002), <http://energycommerce.house.gov/reparchives/107/action/107-116.pdf> (comment of Phillip Leslie Wharton, Vice President of Legal Affairs for the Franchise/License Division, Spherion Corp.).

should be governed exclusively by state contract law; pre-sale disclosure is all prospective franchisees need in order to protect themselves.³⁵ On the other hand, if one characterizes the franchisee as a consumer of a product sold by the franchisor, then one might argue that the franchisee is in need of protection as a consumer of this product.³⁶

For purposes of my analysis, I will characterize the franchise relationship as having some similarities to the sale of common shares in a corporation. This is an imperfect analogy; yet, despite its imperfection, it may be of value in thinking about this relationship.

The franchise relationship generally involves an investment of both money and labor in a business. It is a relationship based upon a contract, albeit a necessarily incomplete contract. This is because the relationship is a long-term relationship that covers a broad range of activities by the franchisor and the franchisee. It is not possible to draft a contract that covers all possible contingencies that could arise during the course of the relationship. Adjustments need to be made over time to respond to competition, changing consumer tastes, economic forces, legal regulations, and many other factors.

In the franchise context, many matters not explicitly decided by the franchise agreement are left to the discretion of the franchisor. However, this discretion is not unbounded; it is limited by the duty of good faith and fair dealing that applies to the performance and enforcement of every contract.³⁷

Given the nature of the franchise relationship, it is hard to categorize the typical franchisee as purely an investor or an entrepreneur. Certainly there are elements of both. In addition to making an often

³⁵ “[T]he marketplace will ensure that the handful of franchise companies that operate with less than scrupulous business practices will not survive the scrutiny of serious business investors. That is why I believe that disclosure protection laws, rather than relationship laws, provide the greatest benefit to prospective franchise investors.” *Franchising Relationship: Hearing Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 106th Cong. 100 (1999), available at http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (last visited Mar. 14, 2009) (statement of Arleen Goodman, representative of the International Franchise Association.). But *cf. id.* at 330 (letter from Michael Einbinder, Rosen, Einbinder, & Dunn, P.C.) (“The inherent conflict between franchisor and franchisee cannot be addressed solely by market forces.”).

³⁶ See *The FTC’s Franchise Rule: Twenty-three Years After its Promulgation: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the House Comm. on Energy and Commerce*, 107th Cong. 5 (2002), <http://energycommerce.house.gov/reparchives/107/action/107-116.pdf> (comments of Rep. Bobby L. Rush posing questions about the franchise relationship, including whether it is a business partnership or a consumer relationship).

³⁷ RESTATEMENT (SECOND) CONTRACTS § 205 (1981). See also generally Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 BARRY L. REV. 61 (2006).

sizeable investment, the franchisee generally manages the day-to-day operations of the franchise unit, which are subject to significant controls imposed by the franchise agreement and operating manual.

The relationship of the common shareholder to the corporation generally involves an investment of money, but usually does not involve an investment of labor.³⁸ Like the franchise relationship, it is based upon an incomplete contract. The basic terms of the contract are set out in the articles of incorporation. However, this contract does not and cannot specify how the managers of the corporation are to act in a myriad of possible business situations. Additionally, the business of the corporation may change over time, and the managers may be faced with opportunities or challenges not contemplated at the time of the shareholder's investment.³⁹ The corporate law regarding fiduciary duties of corporation managers fills a number of the gaps in the corporate contract.⁴⁰

The typical holder of common shares is a passive investor. He or she votes in elections of directors,⁴¹ who generally set overall policy⁴² and appoint officers⁴³ to oversee the day-to-day operation of the business. However, a shareholder in a closely-held corporation who is active in the management of the corporation, or a controlling shareholder of a public corporation, may play a much more "entrepreneurial" role.

In sum, the purchaser of a franchise and the purchaser of common shares both invest in a business enterprise. While one invests in a vertically integrated firm and the other invests in a business that is technically "independently owned and operated," the franchisee invests in a combined economic enterprise involving a "constellation" of entities controlled by a central entity—the franchisor.⁴⁴ In fact, it has been suggested that a

³⁸ To be sure, modern corporation statutes permit the issuance of common shares for future services or services rendered. *See* MODEL BUS. CORP. ACT § 6.21(b) (2002); *cf.* DEL. CODE ANN. tit.8, § 152 (2008).

³⁹ Easterbrook & Fischel have pointed out: "Any system of law that recognizes explicit contracts must deal with gaps and ambiguities." Frank E. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUMB. L. REV. 1416, 1433 (1989).

⁴⁰ *Id.* at 1444-45 ("Corporate law-and in particular the fiduciary principle enforced by courts-fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.").

⁴¹ *See, e.g.*, MODEL BUS. CORP. ACT § 8.03(c) (2002).

⁴² *See, e.g.*, MODEL BUS. CORP. ACT § 8.01(b)-(c) (2002); DEL. CODE ANN. tit. § 141(a) (2008).

⁴³ *See, e.g.*, MODEL BUS. CORP. ACT § 8.40(b) (2002).

⁴⁴ Adolph A. Berle, *The Theory of Enterprise Liability*, 47 COLUM. L. REV. 343, 343-344 (1947). In other contexts, the law on occasion has treated a multiplicity of entities as one where "the reality of the underlying enterprise" diverges from the technical legal structure. *Id.*

franchise system has “firm-like qualities” that “arise from the nature of the restricted bilateral nexus” between franchisors and franchisees.⁴⁵

While it is true that a holder of common shares generally shares in the profits of the entire corporate enterprise and a franchisee’s profits are derived solely from the franchised unit(s) owned by the franchisee, arguably the division of profits in a franchise system is not much different from what might be obtained in a corporation through the use of so-called “tracking shares.”⁴⁶

IV. SECURITIES VS. FRANCHISE INTERESTS

While there are similarities between a franchise interest and common shares, it is not my intent to argue that franchise interests are securities and should be covered by federal and state securities laws.

Common shares (sometimes called “common stock”) are clearly securities, even when a majority (or even all) of the shares are purchased by a party who intends to manage the business (i.e., not a passive investor). In a pair of companion cases,⁴⁷ the Supreme Court rejected the so-called “sale-of-business” doctrine⁴⁸ and held that an interest denominated as “stock” and possessing the usual attributes of common shares is a security. “Stock” is an instrument expressly listed in the definition of “security” under the securities laws⁴⁹ and has a well-settled meaning. The purchaser of common shares purchases a security regardless of whether, based on involvement in the corporation, he or she is perceived as an investor or an entrepreneur.

A franchise interest is not an instrument or interest specifically listed in the definition of “security” under the securities laws. Consequently, for a franchise interest to be considered a “security,” it must fall within the catch-all language in the statutory definition. The Supreme Court has held that the catch-all phrase “investment contract” means “a contract, transaction or scheme whereby a person invests his money in a

⁴⁵ Seth W. Norton, *An Empirical Look at Franchising as an Organizational Form*, 61 J. BUS. L. 197, 199 (1988).

⁴⁶ Tracking shares are “(s)hares issued by a company which pay a dividend determined by the performance of a specific portion of the whole company....” InvestorWords, Definition of “tracking stock,” http://www.investorwords.com/5013/tracking_stock.html (last visited Mar. 2, 2009).

⁴⁷ *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *See also* *Gould v. Ruefenacht*, 471 U.S. 701 (1985).

⁴⁸ M. Thomas Arnold, *The Definition of a Security Under the Federal Securities Law Revisited*, 34 CLEV. ST. L. REV. 249, 249-50 (1985/1986). “The [sale-of-business] doctrine essentially held that the purchase of all, or even a majority, of the stock of a corporation with the intent to manage the business is not a purchase of a security within the meaning of the federal securities laws.” *Id.*

⁴⁹ *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2006).

common enterprise and is led to expect profits solely from the efforts of the promoter or a third party....”⁵⁰ Ordinarily, a franchise interest is not an investment contract, regardless of the investment that the franchisee has made and the importance of the franchisor’s efforts to the success of the franchise.⁵¹ The reason is because the franchisee, either directly or through agents, has the power to control the daily operations of the business and, consequently, the efforts of the franchisee are crucial to the ultimate success or failure of the franchise.⁵²

In short, common shares are a security regardless of the presence of an entrepreneurial intent on the part of the purchaser; a franchise is generally not a security regardless of the extent of the investment by the franchisor and the importance of the franchisor’s contributions to the franchisee’s success.

V. REGULATORY SCHEMES AND ENFORCEMENT: SECURITIES VS. FRANCHISE INTERESTS

Perhaps in part for historical reasons, the offering of securities for sale is subject to extensive federal regulation. In brief, a party making a public offer of securities must file a registration statement with the Securities and Exchange Commission (“SEC”) and provide a disclosure document to offerees.⁵³ The registration statement is reviewed by the SEC.⁵⁴ and generally the actual sale of securities may take place only after the registration statement is declared effective by the SEC.⁵⁵ Securities laws establish both private and public enforcement schemes to remedy violations of the registration requirement as well as any fraud committed during the public sale of the securities.⁵⁶

In contrast, the public sale of franchise interests is subject to a significantly less onerous regulatory system at the federal level. While the Federal Trade Commission’s Franchise Rule requires that a disclosure document be provided to prospective franchisees, there is no requirement that this disclosure document be filed with the Commission (or any other

⁵⁰ S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-9 (1946).

⁵¹ See *Nash & Assoc., Inc. v. Lum’s of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973) (affirming dismissal for lack of federal subject matter jurisdiction; restaurant franchise was not an investment contract); See also *Bitter v. Hoby’s Int’l, Inc.*, 498 F.2d 183 (9th Cir. 1974) (affirming summary judgment; restaurant franchise was not an investment contract).

⁵² *Plum Tree, Inc. v. Seligson*, 383 F.Supp. 307, 310 (E.D. Pa. 1974).

⁵³ Securities Act of 1933 §§ 5, 6, 15 U.S.C. §§77e, 77f (2000). The registration statement must provide very extensive disclosure. See generally S.E.C. Form S-1, <http://www.sec.gov/about/forms/forms-1.pdf>. This is the general registration statement form.

⁵⁴ Securities Act of 1933 § 7, 15 U.S.C. §77g (2000).

⁵⁵ Securities Act of 1933 § 5(a), 15 U.S.C. §77e(a) (2000).

⁵⁶ Securities Act of 1933 §§ 11, 12, 20, 24, 15 U.S.C. §§ 77k, 77l, 77t, 77x (2000).

federal agency or official) and there is no review of the disclosure document by the Commission (or any other federal agency or official). In addition, as discussed above, the Commission's enforcement of the Franchise Rule is spotty and there is no private cause of action for violations of the Rule.⁵⁷

Given the significance of the franchisee interests at stake, the disparity between the strength of the federal regulatory schemes governing the sale of common shares (securities) and franchises is curious.⁵⁸ There is probably no single explanation for this. The catalyst for the federal securities laws was an unprecedented stock market collapse and depression. The continued interest in strong investor protection undoubtedly springs in part from the wide participation of the American public, directly or indirectly, in the stock market. In contrast, the market for franchises has not suffered a cataclysmic event comparable to the stock market crash and certainly there are fewer "buyers" in this market than in the stock market.

In spite of these differences, the franchisee who invests in a franchise (and, in essence, in a franchise system) has a strong interest in meaningful pre-sale disclosure about the nature of the franchise interest that he or she is buying,⁵⁹ as well as about the franchisor and franchise system. In addition, he or she has an interest in meaningful enforcement of pre-sale disclosure requirements, whether by formal or informal mechanisms.

Misconceptions about franchising also may have contributed to the disparity in the federal disclosure schemes. It is likely that many people view franchise systems to be very stable and franchised businesses to be, on the whole, safer and more profitable than non-franchised (independent)

⁵⁷ Susan P. Kezios, President of the American Franchise Association, has stated: "The real problem with the FTC's franchise rule is that it gives the appearance of government oversight without any enforcement. The FTC, despite its staff's good intentions, is truly a paper tiger." *Franchising Relationship: Hearing Before the Subcomm. On Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 60 (1999), available [at](http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm)

http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (last visited Mar. 2, 2009) (prepared statement of Susan Kezios, President, American Franchise Association).

⁵⁸ *Id.* "Franchising is the least scrutinized investment market in the United States today." *Id.*

⁵⁹ Some might argue that the franchisee is not buying but rather merely renting the franchise due to the franchisor's perceived powers to reclaim the franchise interest. See *Franchising Relationship: Hearing Before the Subcomm. On Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 340 (1999), available at http://commdocs.house.gov/committees/judiciary/hju63852.000/hju63852_0f.htm (last visited Mar. 14, 2009) (letter from Steven L. Smith and Shirlee Freudeman-Smith, franchisees, Chem-Dry of Tennessee)("This is no longer 'our business'... we are just renting it from our franchisor").

businesses.⁶⁰ If buying a franchise is a safe investment, then the case for a rigorous pre-sale disclosure scheme is probably not compelling. However, there is evidence suggesting many franchise systems either fail or withdraw from franchising,⁶¹ and that newcomers to franchised businesses tend to have a higher failure rate and lower profitability than comparable non-franchised (independent) businesses.⁶²

VI. PROPOSAL: FRANCHISORS SHOULD BE REQUIRED TO FILE IN ELECTRONIC FORMAT THE PRE-SALE DISCLOSURE DOCUMENT

One striking aspect of federal regulation of franchising is there is so little that has changed since the promulgation of the original franchise rule in 1978. While federal franchise laws have been passed dealing with very narrow segments of the franchising industry,⁶³ numerous bills have been introduced in Congress,⁶⁴ and a number of hearings held without resultant federal legislation. In addition, the process of revising the Federal Trade

⁶⁰ According to the United States Chamber of Commerce, "A good way to reduce your risk of failure is to purchase a franchise because franchises typically have a higher success rate than other types of small businesses. Conventional wisdom holds that franchises have a failure rate of about five percent, compared to the fifty percent failure rate of independent entrepreneurs." See United States Chamber of Commerce, *Franchising*, available at http://business.uschamber.com/P01/P01_3020.asp (last visited Mar. 14, 2009) (also noting studies that question the conventional wisdom).

⁶¹ See Scott Shane, *Final Report: Why New Franchisors Succeed* 6 (Dec. 15, 1996) (report submitted to Office of Advocacy, U.S. Small Bus. Admin.), <http://www.sba.gov/advo/research/rs178tot.pdf> ("Each year between 200 and 300 companies seek to meet this demand for franchising by offering franchises for sale for the first time. However, roughly three quarters of these new franchisors cease to franchise within twelve years of beginning to franchise.").

⁶² See Timothy Bates, *Survival Patterns Among Newcomers to Franchising* 1-36 (U.S. Census Bureau Center for Economic Studies, Working Paper No. 5, 1997), available at http://www.ces.census.gov/index.php/ces/cespapers?search_where=d2hlcmUgaWQ9MTAwMjYx. (last visited Mar. 2, 2009) (Bates' research suggests that newcomers to franchising do not increase their chances for success by associating with a franchise system, that the failure rate for newcomers who purchase existing units is higher than for those who establish new units, and that established, multi-unit franchisees make survival difficult for newcomers); See also Timothy Bates, *Firms Started as Franchises Have Lower Survival Rates Than Independent Small Business Startups* 11 (U.S. Census Bureau Center for Economic Studies, Working Paper No. 3, 1994), available at http://www.ces.census.gov/index.php/ces/cespapers?detail_key=100225 (last visited Mar. 14, 2009).

⁶³ The two federal statutes dealing with franchising in specific industries are the Petroleum Marketing Practices Act, found at 15 U.S.C. §§ 2801-2806, and The Automobile Dealers' Day in Court Act, found at 15 U.S.C. §§ 1221-1226.

⁶⁴ See, e.g., the bills cited *supra* note 3 and *infra* note 81.

Commission's Franchise Rule consumed twelve years⁶⁵ and the end result was a number of good, but not revolutionary, changes in the Rule.⁶⁶

Looking at the system of securities regulation as a model, is there any incremental step that can be taken that will be of benefit to franchisees, not unduly costly or burdensome to franchisors, capable of relatively easy implementation, and useful to policymakers in the future? It is my belief that a requirement that franchisors file with the Federal Trade Commission in electronic format the pre-sale disclosure document that they are required by the Franchise Rule to provide to prospective franchisees is an incremental step that has the potential to provide significant benefits at a modest cost.

The revised Franchise Rule has a number of exemptions. These include new exemptions for large investments of at least one million dollars (excluding unimproved land and any amounts financed by the franchisor), investments by large franchisees with at least five years of business experience and five million dollars net worth, and franchise sales to franchisor insiders who are already familiar with the franchisor's operations.⁶⁷ Under my proposal, the franchisor would be required to file a notice of exemption as to any offerings within one of these new exemptions.⁶⁸

My proposal does not contemplate that the Federal Trade Commission would review the accuracy or evaluate the merits of franchise disclosure documents. Consequently, there would be no need for the FTC to hire examiners for this purpose. In addition, a franchisor would not be required to wait for approval of its franchise disclosure document by the FTC before offering franchises for sale.⁶⁹ Potential franchisees would

⁶⁵ The Rule amendment proceeding began in April of 1995 and culminated in the adoption of the revised Franchise Rule in January of 2007.

⁶⁶ The revised Rule closely tracks the UFOC guidelines promulgated by the North American Securities Administration. The UFOC is already "the national franchise industry standard." Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,444, 15,448 (March 30, 2007) (to be codified at 16 C.F.R. pt.346).

⁶⁷ 16 C.F.R. §§ 436.8(a)(5)-(6) (2007).

⁶⁸ This notice would be similar to the notice of exemption required to be filed under the California act.

⁶⁹ *Cf.* Securities Exchange Act of 1933 § 8, 15 U.S.C. § 77h (2006). This section provides for the effective date of a registration statement filed in connection with a public offering of securities. It authorizes the Securities Exchange Commission to refuse to permit a registration statement to become effective "[i]f it appears to the Commission that a registration statement is on its face incomplete or inaccurate in any material respect." § 8(b). In addition, the SEC may issue a stop order suspending the effectiveness of a registration statement "[i]f it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading." § 8(d).

judge the merits of the franchises offered.⁷⁰ Additionally, inaccuracies in a franchise disclosure document could be exposed by those with an interest in the matter, such as competitors of a franchisor or analysts.

A number of potential benefits could flow from my proposal even absent Federal Trade Commission review of all franchise disclosure documents. First, the filing of these disclosure documents could be of tremendous value to prospective franchisees. The disclosure documents could be made available to members of the public in a system similar to "EDGAR," the SEC's "Electronic Data Gathering and Retrieval System." Making these documents readily available will allow parties considering franchising to choose among franchise systems within an industry or among industries themselves on a much more informed basis because they will have inexpensive and ready access to many franchisors' disclosure documents.⁷¹ In addition, as discussed above, a prospective franchisee may be in a much better position to judge the potential competition he or she will face from other franchise systems before investing in a franchise.

My proposal would likely also promote more market analysis of specific franchise opportunities and of segments of the franchise industry (e.g., fast food franchises) by private analysts and the media, given the ready and low cost availability of franchise disclosure documents. These analyses could be of value to prospective franchisees in valuing and selecting among franchise opportunities. Concomitantly, the review of the documents by franchise market analysts could help discover inaccuracies in such documents and provide an additional incentive for franchisors to file accurate disclosure documents.⁷²

⁷⁰ Cf. U.S. GEN. ACCOUNTING OFFICE, *supra* note 8, at 23 (referring to the Federal Trade Commission's "long-held view that free and informed choice is the best regulator of the market.").

⁷¹ Referring to state filing requirements, one state official stated:

State agencies that require filing of franchise disclosure documents also serve as an important repository of information for prospective franchisees to compare documents from various franchisors. In many instances, this information is crucial to the process undertaken by investors to evaluate franchise deals. Many franchisors do not deliver copies of their disclosure documents to the public upon request.

The FTC's Franchise Rule: Twenty-Three Years After its Promulgation: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Comm. on Energy and Commerce, 107th Cong. 25 (2d Sess. 2002), (prepared statement of Dale E. Cantone, Deputy Securities Commissioner, Chief, Franchise and Business Opportunities Unit, Office of the Maryland Attorney General, Securities Division, on Behalf of the North American Securities Administrators Association).

⁷² The United States Supreme Court has recognized the important function that market analysts play in "the preservation of a healthy [securities] market." *Dirks v. S.E.C.*, 463

It is possible that a system of electronic filing and retrieval would also result in more franchisee-friendly franchise agreements. Some franchisors, aware of the ready availability of the disclosure documents, might decide that they could better compete for the best potential franchisees⁷³ by offering more franchisee-friendly agreements. For example, there are often significant exit barriers for a franchisee at the expiration of a franchise agreement. A franchisee might desire to leave the system but be unable to do so because of a demanding post-termination non-competition agreement. He or she is not free to leave the system but must remain in the same business in the same locality. However, to remain in the franchise system, the franchisee may be required to sign the franchisor's current franchise agreement and make a substantial investment in changes or upgrades to the franchised unit. If the franchisee is unwilling to do this, he or she will likely have to try to sell the franchised unit, but may have to accept a reduced price due to the new investment required.

If franchise disclosure documents are readily available in electronic format, a franchisor might decide to offer franchises in which the franchisee can remain in the same business in the same locality after termination of the agreement, subject to appropriate de-identification of the previously franchised business from the franchise system.⁷⁴ If the franchisor in fact believes strongly in the value of identification with and participation in its system, it might conclude that most franchisees will want to remain with the system at the expiration of their franchise agreements⁷⁵ and that the best

U.S. 646, 658 (1983). Market analysts could play a similarly important role in the market for franchise opportunities.

⁷³ In seeking franchisees, presumably franchisors are seeking both investment capital and managerial skill for the expansion of the franchise system. In fact, an advantage to franchising may be that it allows franchisors to obtain capital and entrepreneurial skills at a "joint supply price . . . is less than the sum of the competitive prices times the quantities of those two inputs separately." See Seth W. Norton, *An Empirical Look at Franchising as an Organization Form*, 61 J. Bus. L. 197, 213 (April 1988).

⁷⁴ Since the typical business format franchise is built around the trademark(s) and other intellectual property of the franchisor, franchise agreements commonly require the franchisee to de-indentify the franchised unit upon the termination of the franchise relationship. De-identification generally requires the franchisee to discontinue use of the franchisor's trademark(s), change or remove distinctive color schemes, uniforms, decorative or architectural schemes, or other combinations of features constituting the distinctive trade dress of the franchisor, and assign existing telephone numbers associated with the unit. See, e.g., *Ramada Franchise Sys., Inc. v. Jacobcart, Inc.*, 2001 WL 540213 (N.D. Tex. May 17, 2001) (granting franchisor preliminary injunction against former franchisee who had not de-indentified formerly franchised unit); *Travelodge Hotels, Inc. v. Coutoules*, 1999 WL 314166 (D. N.J. May 5, 1999) (granting preliminary injunction to franchisor).

⁷⁵ In addition, the franchisor would know that it can install a new franchisee in the area of the former franchisee. If the goodwill associated with the system is strong, the replacement franchisee should be able to compete effectively against the prior franchisee.

franchisees will be initially attracted by offering a more franchisee-friendly agreement.

A system of electronic filing and retrieval might also result in more accurate pre-sale disclosures by franchisors. Franchisors might examine the disclosure documents filed by competing franchisors for accuracy. A franchisor probably has a much greater incentive to examine the disclosure document of a competitor and bring to light any inaccuracies or omissions than any Federal Trade Commission staff member. For example, if a franchisor failed to accurately disclose the required information regarding the business experience of a principal officer or a director, a bankruptcy petition by the franchisor or an officer, or litigation involving the franchisor, a competitor, or anyone else with knowledge of the inaccuracy, could notify the Federal Trade Commission of the violation of the Franchise Rule. Consequently, the proposed electronic filing requirement might result in increased informal enforcement of the requirements of the Rule.

Second, the filing of the disclosure document in electronic format with the Federal Trade Commission should not be unduly costly or burdensome to franchisors. In the twenty-first century, it is likely that the document has been prepared in an electronic format in the first place. In addition, modern technology generally makes it relatively cheap and easy to convert documents from one electronic format to another. Although franchisors may prefer that the information in the disclosure document and attachments, including the franchise agreement itself, not be so readily available to members of the public, the document is likely already available if the franchisor offers franchises in any of the states that require the filing of such documents.⁷⁶ The only question, then, is one of the cost and ease of access for the prospective franchisee (or members of the public) in obtaining the document.

Third, implementing and maintaining a system for electronic filing and retrieval of franchise disclosure documents would involve some cost. However, at least initially, the system would not need to be overly complex, e.g., in terms of search features and other bells and whistles. The question of whether to add frills (and, if so, what advanced functions) could be deferred.⁷⁷ The Federal Trade Commission already permits the electronic filing of consumer complaints⁷⁸ and makes a number of publications and

⁷⁶ For example, if the franchisor has offered franchises in California, the franchise registration (including an offering circular) or a notice of exemption should be available in pdf format from the California Electronic Access to Securities & Franchise Information website. See California Electronic Access to Securities & Franchise Information, <http://www.corp.ca.gov/caleasi/caleasi.asp> (last visited Mar. 14, 2009).

⁷⁷ Perhaps some of the cost could even be defrayed via modest user fees, which might also deter those browsing the filings out of mere idle curiosity.

⁷⁸ See FTC Bureau of Consumer Protection - Consumer Information, <https://www.ftccomplaintassistant.gov> (last visited Mar. 2, 2009).

documents available on its website.⁷⁹ There is no reason to believe that implementing a system for the electronic filing and retrieval of franchise disclosure documents would be a financial or technical challenge to the Commission.

Fourth, a system for electronic filing and retrieval of franchise disclosure documents could be of significant value to policymakers in the future. As discussed above, there is insufficient data regarding franchising generally, as well as the nature and incidence of abusive behavior by franchisors. The franchise disclosure documents filed with the Federal Trade Commission pursuant to this proposal could provide valuable information about franchising generally (e.g. the identity of franchise systems, number of franchise units, etc.), the terms of franchise agreements (e.g., whether they are all the same within an industry so that there is, in effect, no choice), and information about litigation between franchisors and franchisees. While these documents certainly would not provide all the information that may be required by policymakers in the future, they may serve as useful starting point.⁸⁰

Once a system of electronic filing and retrieval is established, it would be possible to “tag” the data or information so that it is retrievable by prospective franchisees and policymakers in a more useful fashion.⁸¹ Since

⁷⁹ See generally Federal Trade Commission website, <http://www.ftc.gov> (last visited Mar. 14, 2009).

⁸⁰ It appears that data gathering was the major purpose of the filing requirement that would have been imposed by bills proposed by former Congressman John LaFalce. These bills would have required filing of franchise disclosure documents with the United States Department of Commerce. See Federal Franchise Data and Public Information Act, H.R. 1317, 103d Cong. § 3 (1st Sess. 1993) and Federal Franchise Data and Public Information Act, H.R. 2595, 103d Cong. § 3 (1st Sess. 1993). The bills would have required the Department to make the filed disclosure documents available to “the Congress, the Federal Trade Commission and other Federal agencies, as requested.” H.R. 1317 § 3(4) and H.R. 2595 § 3(4). In addition, Congressman LaFalce’s bills would have required the Bureau of Census to include statistical information regarding franchise businesses within its Business Census. H.R. 1317 § 4 and H.R. 2595 § 4.

⁸¹ Since 2005, a number of companies have been voluntarily submitting interactive data encoded in a format known as “eXtensible Business Reporting Language” (“XBRL”). Press Release 2007-253, SEC, SEC’s Office of Interactive Disclosure Urges Public Comment as Interactive Data Moves Closer to Reality for Investors (Dec. 5, 2007), <http://www.sec.gov/news/press/2007/2007-253.htm> (last visited Mar. 14, 2009). There are currently three interactive data viewers available to investors to make it easier to get and compare information from company filings with the SEC. See Interactive Data Viewers, <http://www.sec.gov/spotlight/xbri/xbriwebapp.shtml> (last visited Mar. 14, 2009). The SEC has proposed that all public companies be required to provide financial statements to the Commission and on their corporate web sites in interactive data format using the XBRL. This proposed requirement would be phased in over a three year period. See Interactive Data to Improve Financial Disclosure, 73 Fed. Reg.

the information in the pre-sale disclosure documents is already required to be in a substantially standardized format, there would seem to be no reason the data could not be tagged so that important disclosures could be retrieved and compared,⁸² e.g., the estimated initial investment for a franchise,⁸³ or the training program.⁸⁴ Information about franchisor training programs, for example, might be of great interest to a prospective franchisee who takes early retirement (a buyout) after working on an assembly line for many years. Given a lack of business experience, the training and support offered by franchise systems might be critical to his or her investment decision.

Finally, a system for electronic filing and retrieval of franchise disclosure documents at the federal level could be of significant value to states. For example, a state without a franchise disclosure statute could decide to “piggy-back” on this system by providing a state remedy in the form of enforcement actions by state officials, private causes of action, or both, for violations of the Federal Trade Commission’s Franchise Rule’s disclosure requirements.⁸⁵ As discussed above, the Commission has not been able to vigorously enforce its Franchise Rule.⁸⁶ States could decide to fill this gap with state remedies.⁸⁷ The Commission has made clear that it did not intend to preempt franchise laws of state and local governments “except to the extent of any inconsistency” with the revised Franchise Rule and that a law is not inconsistent “if it affords prospective franchisees equal or greater protection.”⁸⁸

VII. IMPLEMENTATION

An important question is whether the Federal Trade Commission has authority to promulgate a rule requiring franchisors to file, in electronic format, the pre-sale disclosure document that they must provide to prospective franchisees. Under the Federal Trade Commission Act, the

32794 (proposed June 10, 2008) (to be codified at 17 C.F.R. pts. 229-230, 232, 239, 240, 249).

⁸² See generally SEC, Enhancing Commission Filings Through the Use of Tagged Data, Concept Release 33-8497, http://www.sec.gov/rules/concept/33-8497.htm#P105_20848 (last visited Mar. 2, 2009).

⁸³ 16 C.F.R. § 436.5(g) (2008).

⁸⁴ 16 C.F.R. §436.5(k)(7) (2008).

⁸⁵ Cf. Federal Fair Franchise Practices Act of 1997, H.R. 2954, 105th Cong. (1st Sess. 1997) (proposed by Congressman John LaFalce). This bill would have created a private cause of action and authorized actions by state attorneys general. H.R. 2954 §§ 7-8.

⁸⁶ The Commission’s staff has indicated that limited resources and other enforcement priorities have contributed to the inability to investigate every complaint. U.S. GEN. ACCOUNTING OFFICE, *supra* note 8, at 14.

⁸⁷ Cf. *Riegel v. Medtronic, Inc.*, 128 S.Ct. 999, 1011 (2008) (stating in dicta that a state damages remedy for violation of a FDA regulation would not be preempted).

⁸⁸ 16 C.F.R. § 436.10(b) (2008).

Commission may prescribe “rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce.”⁸⁹ Such rules “may include requirements prescribed for the purpose of preventing such acts or practices.”⁹⁰ However, before the Commission issues a notice of proposed rulemaking, it must have “reason to believe that the unfair or deceptive acts or practices which are the subject of the proposed rulemaking are prevalent.”⁹¹

The electronic filing requirement would be justified on the grounds that it is a rule designed to prevent deceptive and unfair practices. While the mere requirement that franchisors provide, without filing, a pre-sale disclosure document will reduce deceptive practices in the sale of franchise interests, a requirement that those documents be filed with the Federal Trade Commission should further combat such deception by enhancing the Commission’s ability to monitor the truthfulness of disclosures and representations being made by franchisors when offering franchise interests for sale. The same factors that led the Commission to conclude that there is a continuing need for the Franchise Rule’s pre-sale disclosure requirements should support an electronic filing requirement.⁹² In sum, the Federal Trade Commission should consider promulgating such a rule, following compliance with the appropriate rulemaking procedures.

Regardless, Congress, should it choose to do so, would clearly have the authority, under its commerce powers, to impose a pre-sale filing requirement. In addition, Congress could designate the SEC as the agency to receive such filings, even while leaving the Federal Trade Commission as the agency responsible for enforcing the Franchise Rule. Given the SEC’s experience with electronic filings, this might be a preferable arrangement. Alternatively, Congress could designate the Department of Commerce as the agency responsible for receiving such filings, as was proposed by Congressman John LaFalce in 1993.⁹³ In light of the data

⁸⁹ 15 U.S.C. § 57a(a)(1)(B) (2006).

⁹⁰ *Id.*

⁹¹ 15 U.S.C. § 57a(b)(3) (2006).

⁹² In its Statement of Basis and Purpose, the Commission stated:

Based upon the original rulemaking record and the Commission’s law enforcement experience extending nearly 30 years, the Commission concludes that a pre-sale disclosure rule continues to serve a useful purpose. Overwhelmingly, the comments submitted during the Rule amendment proceeding supported the continued need for the Franchise Rule.

72 Fed. Reg. 15,444, 15,447 (Mar. 30, 2007) (to be codified at 16 C.F.R. pts. 436-437) (footnotes omitted).

⁹³ See Federal Franchise Data and Public Information Act, H.R. 1317, 103d Cong. § 3 (1st Sess. 1993) and Federal Franchise Data and Public Information Act, H.R. 2595, 103d Cong. § 3 (1st Sess. 1993).

collection mission of the Department's Bureau of the Census, this would also be a sensible arrangement. A requirement that such documents be filed with the SEC or the Department of Commerce, as would have been required by Congressman LaFalce's bill, would clearly require congressional approval.

As discussed above, my proposal does not contemplate the hiring of examiners to review the franchise disclosure documents. Consequently, it would be very important that prospective franchisees not be misled into believing that the Federal Trade Commission had reviewed or approved the pre-sale disclosure document. The new Franchise Rule requires a statement on the cover page in bold type: "**Note, however, that no governmental agency has verified the information contained in this document.**"⁹⁴ This alone is likely to be inadequate to prevent prospective franchisees from being misled. Therefore, the Commission should include in its rule requiring the filing of pre-sale disclosure documents a provision declaring that "it is an unfair or deceptive trade practice to make any oral or written statement or representation that suggests or implies that the Federal Trade Commission or any other federal agency has in any way reviewed the contents of the disclosure document, made any finding with regard to the content of such document, or has in any way passed upon the merits of, or given approval to, the franchise opportunity."⁹⁵

VIII. CONCLUSION

In this article I have proposed that franchisors be required to electronically file the pre-disclosure document required by the Franchise Rule. This requirement could have a number of benefits, while not imposing substantial new burdens and costs on franchisors. It would be a reasonable and practical mandate, given the significant investment made by the typical franchisee. In fact, one could argue that the typical franchisee may, in some ways, be more in need of pre-sale disclosure in order to make a good investment decision than the typical purchaser of common shares, for the franchisee often will be required to make a huge investment in the franchised business. Even when the investment made is not so large, it may represent most of the purchaser's net worth. A purchaser of common shares often invests a smaller percentage of his or her wealth in any particular company and, as a result, gains a certain amount of protection

⁹⁴ 16 C.F.R. § 436.3(e)(2) (2008).

⁹⁵ This language draws heavily from the Federal Franchise Data and Public Information Act, H.R. 1317 § 3(a)(5). *Cf.* Securities Act of 1933 § 23, 15 U.S.C. § 77w (2007), making it unlawful to represent or cause representations to the prospective purchaser of a security that the Securities and Exchange Commission has found a registration statement is accurate or does not contain material omissions, or that the SEC has, in any way, passed upon the merits of or given approval to any security.

against loss by virtue of his or her ability to acquire a diversified portfolio.⁹⁶ In addition, a purchaser of common shares in a public company generally has an exit; he or she can easily sell the shares. A franchisee cannot so easily exit the franchise system.⁹⁷ Thus, it may be more critical for the purchaser of a franchise to make an informed investment decision than the purchaser of common shares.

⁹⁶ “Investors can eliminate unsystematic risk by diversifying their portfolio. Diversification eliminates unsystematic risk, because things tend to come out in the wash. One firm’s plant burns down, but another hits oil.” Stephen M. Bainbridge, *CORPORATION LAW AND ECONOMICS* 117 (Foundation Press 2002).

⁹⁷ In this respect, the plight of the franchisee may resemble the plight of the minority shareholder in a closely held corporation who “cannot easily reclaim his capital.” *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 514 (Mass. 1975) (holding that shareholders in a closely held corporation owe each other the same fiduciary duty that partners in a partnership owe to one another).

FRANCHISE SALES REGULATION REFORM: TAKING THE NOOSE OFF THE GOLDEN GOOSE

RUPERT M. BARKOFF*

Franchising is facing a crisis. This crisis has not been highly publicized, but as one tries to review objectively what is happening with franchising, and especially in light of the globalization of the world's economies, it is easy to conclude that the attractiveness of franchising in the United States—which I might characterize as a golden goose¹—is being strangled by government intervention, forcing businesses to use other means to take their products and services to the market place. It is making franchising in the United States a less attractive means of distribution.

Is this “noose” necessary, or are there ways to loosen its grip on franchising and make franchising more viable and friendly to the business community?

Once upon a time, as the fairy tale would recite, franchising was an unregulated means of distribution.² In exchange for some kind of payment or payments, franchisors could freely contract with prospective franchisees, who would receive (1) the right to distribute the franchisor's goods or services using the franchisor's trademarks or service marks, and (2) the right to use the franchisor's system in connection with the sales of those products or services.³ In addition, once the franchise relationship was

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¹ To my knowledge, the first reference to “franchising” in association with the word “gold” was by Andrew C. Selden, Esq. in his article, *Public Regulation of Franchising: Choking the Goose that Lays the Golden Eggs?*, 9 Franchise L.J. 1 (Fall 1989). In his title, Mr. Selden seems to imply that the gold is the derivative of franchising. I sense, however, that franchising itself is viewed as a golden idol; hence, my reference to it as a “golden goose,” which is also the source of the fabled golden eggs.

² Franchising is often mistakenly referred to as an “industry.” It is not. Franchising is one of several methods for companies to provide goods and services to others. According to recent statistics provided by the International Franchise Association (“IFA”), franchising is used in some 75 industries as a means of distribution. INTERNATIONAL FRANCHISE ASSOCIATION EDUCATIONAL FOUNDATION, THE ECONOMIC IMPACT OF FRANCHISED BUSINESSES (PricewaterhouseCoopers 2004), available at http://www.franchise.org/uploadedFiles/Files/EIS6_1.pdf.

³ The legal definition of a “franchise” takes various forms. As noted in the text accompanying notes 5 and 6 *infra*, franchising is regulated at both the federal and state levels.

Federal regulation is under the auspices of the Federal Trade Commission (“FTC”), which has promulgated a trade regulation rule entitled, “Disclosure Requirements and Prohibitions Concerning Franchising,” 16 C.F.R. § 436.1 *et seq.* (the “FTC Disclosure Rule”). Section 436.1(h) of the FTC Disclosure Rule defines a “franchise” as: